SUPREME COURT, U. S.
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IN THE

Supreme Court of the United States

October Term, 1967
No. 265

CHARLES TOWN, Incorporated,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit.

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Opinions Below.

The memorandum findings of fact and opinion of the Tax Court (Appendix, *infra*, beginning at p. 17 thereof) was officially reported as T.C. Memo. 1966-15, and appears in the Commerce Clearing House "TCM" reports at 25 TCM 77. The opinion of the Court of Appeals (Appendix, *infra*, beginning at p. 1 thereof) is reported at 372 F. 2d 415.[1]

Jurisdiction.

The judgment of the Court of Appeals was entered on January 31, 1967. [R. 27.][2] On February 27, 1967,

[1]The appendix to this petition contains the opinion of the court below; also, without omission, the contents of Insert I and Insert III of the certified transcript of record sent up to this Court, in other words, the entire appendices to petitioner's briefs in the court below, including the findings and opinion of the Tax Court.

[2]The "R." references are to the indicated pages in the certified transcript of record.

the time for filing in said court petition for rehearing was extended to and including March 17, 1967. [R. 32.] Petition for rehearing was filed March 13, 1967. [R. 33.] The said petition was denied March 23, 1967. [R. 40.] The jurisdiction of this Court is based on 28 U.S.C. §1254(1).

Question Presented.

The question presented is whether, under the facts as found by the Tax Court, the Commissioner of Internal Revenue, pursuant to Section 482 of the Internal Revenue Code of 1954, properly allocated to petitioner, which conducted two race meeting ventures, income received by another corporation from the said ventures as its contractual share of the profits thereof for the use and risk of money furnished by it.

Statutes and Regulations Involved.

The statutory provision applied by the Tax Court and the Court of Appeals here is Section 482 of the Internal Revenue Code of 1954, reading as follows:

> "§482. Allocation of income and deductions among taxpayers.
>
> "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

Respondent, as the Court of Appeals notes, also relied on Section 61 of that Code. (App. 2.)[3]

As to related Treasury regulations, both courts below set out by footnote the full text of Section 1.482-1(c). It is quoted as part of their opinions in the Appendix hereto. (App. 8, 63.) The Court of Appeals, however, as shown in the Appendix hereto (App. 9), also cited and quoted from Section 1.482-1(a)(3) of those regulations.

Statement.

This is an income tax case. The Tax Court sustained the action of respondent, the Commissioner of Internal Revenue, in allocating to petitioner, Charles Town, Incorporated, hereinafter referred to as "Charles Town," income reported by another corporation, Fairmount Steel Corporation, hereinafter referred to as "Fairmount." The Court of Appeals affirmed.

The tax years of petitioner involved are fiscal years ended November 30, 1958, and November 30, 1959. As stated by the Court of Appeals, the "Commissioner's allocation under Section 482 [was] predicated on the alleged shifting of profits from one controlled entity (Charles Town) to another (Fairmount) for the purpose of utilizing net operating loss carryovers of the latter." (App. 1-2.) Fairmount, as the court below also stated, was controlled at all relevant times by two brothers, Ben and Herman Cohen. They also controlled other business enterprises including Housing

[3]The "App." references are to the pages of the Appendix hereto, without regard to the numbers of the pages from which derived.

Engineering Corporation and C. B. Associates, a partnership which succeeded Housing Engineering Corporation upon its liquidation in April 1958. (App. 3.) Whether, under the facts as found by the Tax Court, the relation of the Cohen brothers to Charles Town at the relevant time constituted control of that entity also, presents one of the problems in this case.

Charles Town was incorporated in West Virginia for the purpose of operating a race track. (App. 24.) The West Virginia Racing Commission in May 1958 had issued an ultimatum to one Mrs. Boyle, owner of a race track in the city of Charles Town, that if a summer meet were not operated on that track it would take her license away. On May 20 she executed a lease of the track, for the period May 22, 1958, to September 10, 1958, to "Ben Cohen, acting for Charles Town, Incorporated, a corporation to be hereinafter created under the laws of the State of West Virginia." (App. 23.) Fairmount gave Mrs. Boyle at the same time a check for the agreed rental of $225,000. On May 22, 1958, it gave her an additional $15,000 pursuant to supplemental agreement entered into on that date. (App. 26.)

On that date, also, Charles Town, the corporation, was incorporated. Pursuant to previous subscription (App. 81), it then issued 100 shares at $10 each, one each to Ben and Herman Cohen and the other 98 to Louis Pondfield (App. 24), a first cousin of the Cohens who had been connected with horse racing since 1920 and had been a manager of racing meets since 1949. (App. 21, 71-72.)

In its application to the Racing Commission for a license Charles Town disclosed, in response to a question therein as to what persons had, other than as shareholders, "advanced, by loan or otherwise, the capital invested in the business," that such person was Fairmount and that the amount of capital so advanced was $500,000. (App. 36, 80.) The Commission was also at the same time informed that Pondfield would manage the meet. (App. 87-88.)

On May 20, 1958, concurrently with the execution of the lease on that date, an agreement was entered into between Fairmount and Charles Town. Under said agreement Fairmount agreed to provide "all monies necessary" for operating the meet, and in a minimum amount of $450,000, and Charles Town agreed to operate the meet. (App. 30-31.) The agreement further provided that Charles Town would get 10 per cent of the profits "for its services" in such operation, and Fairmount would get the other 90 per cent for its said financing of the meet and would bear entirely any loss. It was executed on behalf of Fairmount by Herman Cohen and on behalf of Charles Town by Pondfield. Also, pursuant to the agreement, Ben and Herman Cohen were placed on the board of directors of Charles Town, for "so long as Charles Town shall be indebted to Fairmount"; and they were empowered as the board majority "to make all major decisions as to the allocation of income and expenses and in the management of the race meet." (App. 29-32.) This was done to protect the funds advanced by Fairmount against misuse by Pondfield. (App. 74.) Moreover, the Cohens did not interfere in his management of the meet. (App. 73.)

Under an identical but subsequent and entirely separate agreement, expressly approved by Pondfield as well as the Cohens (App. 84-85), a second racing meet was conducted, during the period November 20, 1958, to February 20, 1959. In the case of each meet each sum advanced by Fairmount was advanced by it for a specified use in connection with that meet. For each meet, also, the advances so made consisted almost entirely of just two items, the rent, and "bankroll," the latter being the money necessary to be on hand to start a day's wagering operations. (App. 27-28, 67-68, 75-76.)[4]

The income from the racing meets was divided by the two entities in accordance with their agreement and was so reported on their income tax returns. (App. 6, 45-46.) There is clear and uncontradicted testimony that the division between them was fair, that it was, in fact, just what one would expect between parties dealing at arm's length, as evidenced by meets operated by Pondfield when the Cohens were not involved. (App. 74.) There is absolutely no evidence and no finding to the contrary. The "operation" in the case of each racing meet was the only duty assumed by Charles Town in its respective contract with Fairmount; the entire

[4]The total actually advanced by Fairmount for the first meet, all of it advanced in May 1958 and repaid in full by August 9, 1958, was $479,025.00; and the total actually advanced by Fairmount for the second meet, all of it advanced in November and December, 1958, and repaid in full by February 10, 1959, was $507,500.00. (App. 26-27, 67-68.) The Tax Court and the Court of Appeals added those two sums together, disregarding the intermediate repayment of the first sum, so as to derive as made "available" by Fairmount to Charles Town a total of $986,525.00 (App. 5, 58)—this for the purpose of relating to it as a "like" amount, and therefore as its source, a sum of $900,000.00 received by Fairmount from Housing in March 1958. (App. 3, 58.) However, we base no contention on this bizarre piece of logic.

financing, and the entire bearing of any loss, were the duties correspondingly and expressly assumed by Fairmount. (App. 30-31.) There is a finding by the Tax Court that the total net income from the "operation" of the two racing meets was produced and earned by Charles Town. (App. 52.) There is no finding that the total net income attributable to performance by both parties, in other words, to the operation, *and the entire financing and bearing of any loss,* was produced and earned by Charles Town. The Commissioner, nevertheless, sustained by the courts below, treated the entire income from each racing meet as the income solely of Charles Town. (App. 15.)

Reasons for Granting the Writ.

1. The decision below is in clear conflict with the decision of the Ninth Circuit in *Rooney v. U.S.*, 305 F. 2d 681. The opinion below takes the form of quoting from that case, agreeing with it, and then distinguishing it. (App. 9.) But the attempted distinction, on the very face of the opinion below, merely confirms and emphasizes the conflict.

In *Rooney* it was held, 305 F. 2d at page 683, as quoted by the court here below, that common control, to require application of Section 482, must exist "when the taxpayers deal with each other." It was there also held, at the same page, that "control at another time is unimportant." Also, these holdings there were necessary to the decision there.

Obviously, then, under the holding in that case, as a requisite to the application of Section 482 the common control must have existed here when each agreement

between Fairmount and Charles Town was made. Therefore, it could not be based upon that same agreement.

Now, as to the first agreement, the opinion below, to show that the common control was not based by it upon that agreement, says that that agreement was "only one of several facts . . . by which their [the Cohens'] actual and effective control of the corporation was acquired and exercised." (App. 9-10.) In direct conflict, however, it then recites as the facts referred to a "course of events," *including "the execution of the agreement"* (italics supplied), none of which except the agreement itself could have given them any control over Charles Town, 98 per cent of the stock of which was owned by Pondfield.

The Court of Appeals next attempts to avoid that effect by suggesting that even if the Cohens were not, at the relevant time, in control of Charles Town, they were then in control of "the *business* known as Charles Town, Incorporated." (App. 10, italics in original.) But the entity to which the income was allocated under Section 482 is the petitioner here, the *corporation*. The control required is therefore clearly of the corporation, not the "business."

Finally, the opinion then says (App. 10), "Pondfield *gave up* the control he could have exercised as majority stockholder when he permitted Charles Town" (italics supplied) to enter into the agreement. There again the opinion itself makes clear that, except for the agreement, and to the extent of the agreement, the control of Charles Town was not in the Cohens, it was in Pondfield.

The same reasoning applies to the second agreement, since the first agreement, by its express terms, applied only to the one meet. (App. 29-32.) That was obviously why, when the second meet was agreed upon, Pondfield as well as the Cohens approved it. (App. 84-85.) So again, except for the agreement, and to the extent of the agreement, the Cohens had no control of Charles Town.

Thus the opinion below, on its face, in attempting to distinguish the *Rooney* case, shows all the more clearly that it is in direct conflict with that case, that the situation here fails to meet the requirement of that case that the common control exist "when the taxpayers deal with each other."

2. The decision below is also in clear conflict with that of the Tenth Circuit in *Davis v. United States*, 282 F. 2d 623. That case involved Section 45 of previous internal revenue law, the forerunner, without substantial change, of present Section 482. As that case shows, at page 627, the section cannot be applied, even if there is common control, if the division of the income between the entities is what it would have been "had they been dealing at arm's length." To the same effect are the following cases, in which, as in *Davis*, there was common control, but which were decided for the Commissioner because, in addition, the division of the income between the entities involved was found not to be what it would have been had they been dealing at arm's length: *National Carbide Corp. v. Commissioner*, 336 U.S. 422, 438; *South Texas Rice Warehouse Co. v. Commissioner* (C.A. 5), 366 F. 2d 890, 897, cert. denied, April 24, 1967; *Oil Base, Inc. v. Commissioner* (C.A. 9), 362 F. 2d 212, 214, cert. denied, Nov. 7,

1966; *Eli Lilly & Co. v. U.S.* (Ct.Cls.), 372 F. 2d 990, 1000. To the same effect are the related Treasury regulations. (App. 8, fn. 4, last sentence.) The *Davis* case also shows, at page 627, that the fact that Fairmount here was able to offset its own net operating losses against the income from the meets is wholly irrelevant.

There is here no finding, nor a single scintilla of evidence to support a finding, that the share of the income received by Fairmount was not fair and just compensation to it for the use and risk of the money furnished by it. The clear evidence to the contrary, showing that the division of the income between Fairmount and Charles Town was in accord with experience in the case of parties dealing at arm's length (App. 74), is wholly uncontradicted.

There is also no finding as to what fair and just compensation to Fairmount for the use and risk of the money furnished by it should be, if not the amount which it received. There is not even a finding that the evidence was inadequate for that purpose.

We submit, therefore, that the decision below is in clear conflict with the decision of the Tenth Circuit in *Davis, supra.*

3. This case is important because it presents, on its face, a clear denial of the due process of law required by the Fifth Amendment.

Under each of the two contracts between Fairmount and Charles Town, the funds were advanced by Fairmount for a specific short-term purpose, a single racing meet, and only for the period of the meet, and only, moreover, for specified uses in connection with the meet.

Fairmount furnished the use and risk of the money, and Charles Town the operation. And in substance, each contract was one between the Cohens, on the one side, as owners of Fairmount, and Pondfield, on the other side, as the owner of Charles Town, and therefore clearly at arm's length. Indeed, the court below concedes they were at arm's length, for it says that the reason, in its view, why the clauses requiring Fairmount to bear entirely any loss were inserted in each contract was "to prevent Fairmount from charging back any of its capital losses against Charles Town." (App. 14.)

In that situation to charge Charles Town with tax on the share of the income belonging to, and received by, Fairmount, is a plain violation of due process. As this Court held in *Hoeper v. Tax Commission*, 284 U.S. 206, it is a violation of due process to tax the income of one person to another, even though they be as closely related as husband and wife. Of course, we do not suggest that Section 482 of I.R.C. 1954 was so intended; but that is how the Tax Court and the Court of Appeals have here applied it.

This violation of due process is emphasized by the "business" which, as shown in Reason 1 above, the court below conjured up as a separate entity in order to show control of petitioner by the Cohens. Who owned that other entity? Was it perhaps the petitioner and Fairmount? The court below does not say. This attempt to impose a tax on petitioner here, because of control by the Cohens of some other entity, is in effect to tax petitioner on the income thereby allocated to that other entity, again in the teeth of the *Hoeper* case.

The principle so announced in the *Hoeper* case, that one person cannot be taxed on the income of another, is clearly applicable here. The decision below is palpably in conflict with the rule in that case.

4. This case also important because the interpretation of Section 482 below would make that section invalid due to vagueness, and therefore presents an important issue of general statutory construction.

This Court stated, in *Ashton v. Kentucky,* 384 U.S. 195, 200 (1966): "Vague laws in any area suffer a constitutional infirmity." This applies to any law lacking in objective standards with the result that the law's administrator is given unlimited discretion. *Louisiana v. United States,* 380 U.S. 145, 150, 152-3 (1965).

Under the Treasury regulation applied here by the court below in defining the term "control," as used in Section 482, that term includes, as quoted here by that court from the said regulation, "any kind of control . . ., whether legally enforceable, and however exercisable or exercised." (App. 9.) This is solely the regulation. There is nothing in the statute itself to give the term "control" that scope. And it is that scope, at least, which the court below has applied. To the extent to which the regulation enlarges upon the statute, the regulation is necessarily void. *Manhattan General Equipment Co. v. Commissioner,* 297 U.S. 129, 134; *United States v. Ogilvie Hardware Co., Inc.,* 155 F. 2d 577, 580 (C.A. 5), affirmed 330 U.S. 709, 1 Mertens §3.21, at fns. 81, 82.

Assuming, however, that that is what the statute means, it is so vague that no interpretation can save it.

Here, as already observed in Reason 1 above, the court below attempts to show the Cohens' control of Charles Town by the "course of events which led to the creation of Charles Town," (App. 10) as though control is the series of preceding events, rather than what it is, a presently existing power. If, indeed, that is what the term "control," as used here, can mean, there are no boundaries at all to its meaning. If that is what the statute means, then the statute itself is void. *Ashton v. Kentucky, supra*; *Louisiana v. U.S., supra.*

We submit for that reason that this case is of great importance, not only in the administration of the revenue, but in every other field in which statutory construction is involved.

Conclusion.

Therefore, for the reasons stated above, petitioner prays that this Court issue the writ of certiorari sought herein to the United States Court of Appeals for the Fourth Circuit.

Respectfully submitted,

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